DP/1999/CRP.9
17 May 1999

ORIGINAL: ENGLISH

Annual session 1999
14-23 June 1999, New York
Item 14 of the provisional agenda

Comments on the report of the Advisory Committee on Administrative and Budgetary Questions (DP/1999/26) ...

I. INTRODUCTION

1. In March 1999, the Advisory Committee on Administrative and Budgetary Questions (ACABQ) completed a review of the report of the Administrator on UNDP financial risk management; review of the operational reserve (DP/1999/5/Rev.1). The ACABQ report, contained in document DP/1999/26, was presented to the Executive Board at its second regular session 1999.

2. The Executive Board took note of the two reports and decided to resume consideration of these documents at its annual session 1999.

3. The present paper provides the Administrator's comments on the issues identified by ACABQ. It proposes a modification to the formula for the calculation of the operational reserve proposed in document DP/1999/5/Rev.1. This modification is intended to meet the concerns of ACABQ regarding the level of the reserve while retaining the improvements inherent in the revised formula.

II. BACKGROUND AND ISSUES RAISED BY THE REPORT OF ACABQ

4. The major elements of financial risk faced by UNDP and the means of managing that risk are reviewed in document DP/1999/Rev.1. Three substantive elements are covered: (a) the adequacy of the current level of the operational reserve for regular resources and the formula used for its calculation; (b) a definition of the term liquidity as it applies to the financial activities of UNDP, together with an indication of the levels of liquidity required by the organization; and (c) the recommendation for a separate reserve to cover the risks associated with the management by UNDP of other resources.

5. In commenting on document DP/1999/5/Rev.1, ACABQ notes in paragraph 4 of its report that the Advisory Committee had previously expressed the view that

the need to maintain a reserve at the $200 million level should be reviewed (A/53/513, para. 54). The ACABQ opinion is based on the assumption that the current reserve level may be too high, given the fact that UNDP had used the reserve only once in recent years (in 1994) for a short period.

6. ACABQ further expressed the view (para. 6) that the document does not provide a satisfactory review of the actual experience of UNDP with regard to the risk elements identified. In addition, the Advisory Committee noted that the approach followed by UNDP appears to be judgemental and theoretical.

III. COMMENTS ON THE ISSUES RAISED BY ACABQ

7. In response to the issues raised by ACABQ, the Administrator first wishes to highlight that the review confirms that the level of the operational reserve for regular resources, as determined by the current formula, is adequate to protect UNDP. Indeed, the difference in amounts determined by the two formulas is relatively minor in comparison to the size of the UNDP programme.

8. Second, the Administrator wishes to draw the attention of the Executive Board to the improvements provided by the revised formula, particularly as it relates to transparency and stability. ACABQ has not specifically commented on the relative merits of the two formulas.

9. Third, the Administrator agrees that the basis for determining the need for any single component of risk to be covered by the operational reserve is judgemental. Such judgements are based on an assessment by management of the nature of the risks and the reasons they might occur, as noted in document DP/1999/5/Rev.1. However, the Administrator does not believe that the revised formula is more judgemental or theoretical than the current one.

10. With regard to the past use of the operational reserve, the Administrator does not believe that the lack of a need to utilize the resources of the reserve in recent years justifies a lower level of reserve. It is important to note that during the 1990s, UNDP operated with a very high level of liquidity resulting from slow delivery due to a variety of causes, of which the Executive Board is aware. This high level of liquidity reduced the likelihood of any need to draw against the resources of the operational reserve. Those conditions no longer exist, and the level of UNDP liquidity has been greatly reduced, significantly increasing the probability that the reserve will be needed in the future. The reserve is intended to cover future risks; past inefficiencies in resource management cannot be the basis of an assessment of future requirements for risk coverage.

IV. BENEFITS OF THE REVISED FORMULA

11. The revised formula differs from the current formula in three key respects:

(a) It is based on historical levels of income and expenditure rather than on a forecast as with the current formula; this feature improves on the transparency of the calculation;

(b) It averages the effects of both income and expenditures rather than choosing the higher of the two as with the current formula, resulting in more stability in the level of the reserve on a year-to-year basis;

(c) It specifies the degree of liability risk it intends to cover, a feature not specifically articulated in the current formula.

V. PROPOSED MODIFICATION TO THE REVISED FORMULA

12. As noted above, the difference in the level of the optional reserve as calculated by the current versus the revised formula under existing conditions is minimal in relation to the size of the UNDP multi-year programme. Nevertheless, in order to take into consideration the view of ACABQ that the reserve should be kept at its existing level, the Administrator proposes a solution that would retain the benefits of the proposed revised formula while maintaining the reserve at its current level.

13. As noted in paragraph 33 of document DP/1999/5/Rev.1, liability and structural risks are unknown and unpredictable. This makes it difficult to use a strict formula to determine the protection needed. For that reason, the revised formula determines the level of the component of the reserve for such risks as a function of the income and expenditure of the organization. In doing so, it uses a factor of 25 per cent of the calculated income and expenditure components of the reserve to assign a lump-sum amount to cover liability and structural risk to the reserve.

14. Recognizing the judgemental nature of such a factor, the Administrator now proposes to reduce the factor used to calculate the liability and structural risk component of the reserve from 25 per cent to 10 per cent. Doing so would result in an operational reserve for regular resources in 1999 of $183 million, as compared to an amount of $180 million if calculated under the current formula, and compared to $197 million under the revised formula, as originally proposed.

15. The following illustration presents the effects of the proposed change on the levels of the operational reserve over the past three years under each of the formulas under consideration, i.e., the current formula, the revised formula and the modified version of the revised formula.

Operational reserve level: effects of the proposed change
(In millions of dollars)

Year	Income	Expenditure	Operational Reserve		
			Current	Revised	Modified*
1995	900	801	200	-	-
1996	848	847	170	-	-
1997	761	975	200	203	187
1998	750	914	180	208	193
1999	760	900	180	197	183

* Structural/liability element calculated as 10 per cent of income and expenditure components, reduced from 25 per cent originally proposed.

The volatility associated with the current formula can be readily noted in the changes of $30 million between 1995 and 1996, and again between 1996 and 1997, followed by a swing of $20 million from 1997 to 1998. Under the modified revised formula, the volatility is greatly reduced.

VI. EXECUTIVE BOARD ACTION

16. The Executive Board may wish to adopt the following decisions:

(a) Take note of the report of the Administrator (DP/1999/5/Rev.1);

(b) Note the approach recommended by the Administrator to determine UNDP liquidity;

(c) Support the recommendation of the Administrator for the establishment of a reserve for Other Resources activities and the mechanism for its funding;

(d) Approve the recommended formula for the calculation of the level of the Operational Reserve for regular resources; and decides to reduce the factor used to calculate the liability and structural risk component of the reserve from 25 per cent to 10 per cent.